Internal Revenue Service

memorandum

CC:FS-TL-N-467-92
JMSchwartzman

date: NOV 26 1991

to: District Counsel, ST. Paul CC:STP

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This memorandum responds to your request concerning the "mirror" transactions involving [redacted]. Specifically, the issue is whether taxpayer's purchase of the [redacted] affiliated group through subsidiaries and the subsequent liquidation of the members of that group, followed by taxpayer's sale of some of [redacted]'s businesses, qualified as a valid, pre-1987 "mirror" transaction, thereby effectively avoiding tax on the sale of appreciated assets at the corporate level. As described in more detail below, we conclude that this transaction qualified as a valid, pre-1987 "mirror" transaction and, thus, that the corporate-level gains and losses reported by [redacted] should not be challenged.

ISSUE

Whether [redacted]'s purchase of the [redacted] affiliated group through subsidiaries formed for that purpose and the subsequent liquidation of the members of the [redacted] group into their "mirror" subsidiaries, followed by [redacted]'s sale of some of [redacted]'s businesses qualified as a valid, pre-1987 "mirror" transaction.

FACTS

[redacted] ([redacted]) was the common parent of an affiliated group of corporations filing returns on a consolidated basis.

In [redacted], [redacted] purchased [redacted] shares of [redacted] ([redacted]) common stock and an option to purchase an additional [redacted] shares. It also initiated a tender offer to purchase [redacted] shares of [redacted] through its wholly-owned acquisition

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subsidiary, [redacted] ([redacted]). This initial tender offer was resisted by [redacted]'s management, but, on [redacted], [redacted] and [redacted] entered into an agreement to purchase [redacted] shares of [redacted] stock from its shareholders, followed by the merger of [redacted] into [redacted] in exchange for the remaining [redacted] shares.

On [redacted], [redacted] formed [redacted] first-tier subsidiaries, [redacted] through [redacted] (the mirror subsidiaries), which were funded with approximately $[redacted] of liquid assets. Each corporation was funded with an amount approximating the value of the [redacted]'s [redacted] operating units. The [redacted] mirror subsidiaries then formed a partnership, [redacted], to coordinate their activities. On [redacted], [redacted] assigned its right to purchase [redacted] shares of [redacted] and the option to purchase [redacted] shares to the [redacted] mirror subsidiaries, which transferred the right and the option to [redacted]. The mirror subsidiaries also funded [redacted] with the $[redacted] liquid assets, which [redacted] used to exercise the right to purchase [redacted] shares and exercise the option to purchase [redacted] shares. [redacted] also held the [redacted] shares initially purchased by [redacted], for a total of [redacted] shares.

On [redacted], [redacted] merged into [redacted]. The remaining [redacted] shares held by the public were converted into rights to receive [redacted]% Senior Subordinated Debentures. [redacted] was then dissolved and the [redacted] shares it held were distributed to the [redacted] mirror subsidiaries in proportion to their former interests in [redacted].

On [redacted], [redacted] adopted a plan of complete liquidation. To facilitate the disposition of certain [redacted] operating units, [redacted] merged some of the [redacted] mirror subsidiaries and changed the name of the new merged entities, as follows.

1) [redacted] and [redacted] merged. The surviving entity was renamed [redacted];

2) [redacted] and [redacted] were merged. The surviving entity was renamed [redacted];

3) [redacted] and [redacted] were merged. The surviving entity was renamed [redacted];

4) [redacted] changed its name to [redacted]; and

5) [redacted] changed its name to [redacted].

At that time, no changes were made to mirror subsidiaries [redacted], [redacted], [redacted], [redacted] and [redacted].

On [redacted], the following distributions in redemption of the [redacted] stock took place.

1) All the outstanding shares of [redacted] were distributed to [redacted];

2) All the assets and liabilities of [redacted] were distributed to [redacted];

3) All the outstanding shares of [redacted] were distributed to [redacted];

4) All the outstanding shares of [redacted] were distributed to [redacted];

5) All the outstanding shares of [redacted] were distributed to [redacted]; and

6) All the outstanding shares of [redacted], [redacted] [redacted] and [redacted] were distributed to [redacted].

In addition, the following distributions in redemption of [redacted] stock took place. In [redacted], [redacted] distributed all the outstanding stock of [redacted] to [redacted]. In [redacted], [redacted] distributed $[redacted] to [redacted] and distributed all of the outstanding stock of [redacted] to [redacted] in [redacted]. By the end of the following calendar year, [redacted], [redacted] completed its liquidating distributions and all remaining assets of [redacted] were distributed to [redacted].

From [redacted] until [redacted], [redacted] entered into contracts for the sale of the stock of six [redacted] mirror subsidiaries. The gain or loss on the sales of those subsidiaries were calculated by subtracting [redacted]'s adjusted basis in each subsidiary from the amount realized on each sale.

ANALYSIS

When [redacted] liquidated, no corporate level tax was triggered because of the section 332 exception set forth in section 337(a). *See* section 336. The 80% required stock ownership for [redacted] to liquidate tax free included the stock owned by all members of the [redacted] consolidated group. Treas. Reg. § 1.1502-34. The distribution of [redacted]'s operating units to each of the mirror subsidiaries, as opposed to a pro-rata distribution of each operating unit to each subsidiary, is respected for tax purposes. *See* Rev. Rul. 83-61, 1983-1 C.B. 78. The stock or assets of [redacted]'s operating units have a carryover basis in the hands of the mirror subsidiaries. Section 334(b)(1).

[redacted]'s basis in its mirror subsidiaries equaled the amount of liquid assets distributed to each upon their formation. Sections 351 and 358. Thus, gain or loss on [redacted]'s subsequent disposition of some of the subsidiaries was determined by reference to such bases. Section 1001(a).

We conclude that the Service cannot successfully challenge taxpayer's transaction under the step-transaction doctrine, section 269 or section 482.

In *Commissioner v. Court Holding Company*, 324 U.S. 331 (1945), the Supreme Court held that a corporation was taxable on the sale of its assets where the corporation had negotiated the sale, but had distributed the assets to its shareholders to complete the sale in order to avoid corporate-level tax. The Court stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. *Court Holding Company*, 324 U.S. at 334.

The *Court Holding Company* case was distinguished in *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950). There, the shareholders attempted to sell the stock of their corporation. The purchaser rejected that offer and counteroffered to purchase from the corporation certain assets of the corporation. The shareholders rejected that offer. The parties finally agreed that the corporation would liquidate and that the shareholders would sell the desired assets to the purchaser. The Court upheld the Claims Court's factual findings that the sales were negotiated and entered into by the shareholders and not the corporation.

On our facts, it may be argued that [redacted], [redacted], [redacted] and, possibly [redacted] were sold by [redacted] and not by [redacted] because the sales contracts were entered into prior to or shortly after [redacted] commenced its liquidating distributions. On the other hand, a *Court Holding Company/Cumberland Public Service* analysis of these facts strongly suggests that [redacted] was the seller because [redacted] alone negotiated the sales and [redacted] alone entered into the contracts for the sales of the mirror subsidiaries.

There is some language in a footnote of Treasury Secretary Baker's December 9, 1986 letter to House Ways and Means Committee Ranking Minority Member John J. Duncan intimating that the step-transaction doctrine may be applicable in prearranged mirror transactions. Though this language raises some uncertainty regarding the applicability of that doctrine to this transaction, we believe that the Service should not challenge [redacted]'s acquisition of [redacted] and its subsidiaries based on the facts of this case.

We believe that section 269 does not apply on these facts. Section 269 applies when tax evasion or avoidance outranks or exceeds in importance any other purpose of the transaction. *See Canaveral Internal Corp. v. Commissioner*, 61 T.C. 520 (1974). In this case, we believe [redacted] intended to purchase and retain some of the operating units of [redacted] and executed the purchase in the most tax advantageous form. *Cf. Cumberland Public Service Co., supra*, with *Gregory v. Helvering*, 293 U.S. 465 (1935). Though the acquisition could have taken different forms which would have resulted in greater tax liability to the parties to this transaction, those other forms were not employed.

We also believe that section 482 does not apply to this transaction. Section 482 applies when income has been assigned to a controlled party who did not earn it or when the terms of an agreement between controlled parties are not arm's-length. In this case, there has been no assignment of income and no agreements with nonarm's-length terms.

CONCLUSION

We conclude that [redacted] intended to purchase and retain some of [redacted]'s operating units. It does not appear that the primary purpose of this transaction was tax avoidance or evasion. Thus, section 269 does not apply. In addition, because there has been no assignment of income and no nonarm's-length agreements between related parties, section 482 does not apply. Moreover, although Treasury Secretary Baker's letter creates some certainty as to the application of the step-transaction doctrine in this case, we believe the sales of [redacted]'s operating units cannot successfully be imputed to [redacted]; perhaps under the *Court Holding Company* analysis. Because [redacted] negotiated the sales and entered into the sales contracts, *Cumberland Public Service* presents too great a litigation hazard. Accordingly, we conclude that the corporate-level gains and losses reported by [redacted] should not be challenged.

If you have any questions, please contact Jerry Schwartzman at FTS 566-3335.

We note that this memorandum is for **COUNSEL USE ONLY.**

DANIEL J. WILES

By: ______________________
ALFRED C. BISHOP, JR.
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